

# FRIEDBERG'S

## COMMODITY & CURRENCY COMMENTS

Friedberg Commodity Management Inc.



Volume 5, No. 1 January 8, 1984

## 1983—the year that wasn't . . .

In fact, it wasn't apocalyptic, catastrophic, or even thrilling. As far as futures markets were concerned, it was downright dull. Not even funny. Laughable maybe, especially when reviewing some of the hyperbolic prose we often used to forecast prices and events, but not funny. The world did not collapse into a paroxysm of default; banks still exist, crude oil did not fall to \$8 per barrel.

Of course there were the occasional highs and even the less occasional lows. But generally speaking it was a banal year, an uninspiring year, a year hardly worth remembering at all. Let's dispense with it quickly then, in this the second annual year-end review.

### Highlight of the year

Being long the US dollar: Here was a prediction to be proud of in any 12-month period. Not a single analyst comes to mind who did not join the bold herd of sheep predicting the end of the three-and-a-half-year reign of the greenback. We stood alone. We got short the D-mark, the Swiss, and the yen in May—we had been short the French franc throughout the year—and added to our position in June, stating in defiance of all those who pointed to the obvious US trade deficit, that capital flows into America had been, and would continue to be, positive: "The US dollar is neither too high nor too strong." By nimbly switching from the Continental currencies back and forth into Sterling, we reaped profits enough to turn the entire year into a winning one.

### Lowlight of the year

In fact the bulb blew altogether: Being long gold from January through March. The nadir was reached in our March letter when we advised adding to long positions and neglected to offer a protective stop. Thirty days later, when the market was \$100 an ounce, or \$10,000 per contract, lower, we found ourselves running about to see whether there could possibly have been a typographical error in our March Comments or our March statements. (There wasn't.)

### Second highest light of the year

Short gold. Throwing aside the same charts every other astrologer and savant divined, we asked ourselves in May: "Is there a method of determining whether gold has entered a new bull market? We seriously doubt it. Is there, on the

other hand, a method of determining whether gold is fairly priced at . . . \$435/ounce?" There was. It involved the deflation of the admittedly huge government deficit by the size of its gold holdings. That done, we concluded gold was overvalued. The \$70 per ounce decline since then, while not fully paying for our disastrous no-light long position, was more than small recompense.

### We are impugned

The most overused and inappropriate word used in these *Comments* was "impunity." "Look for the market to fall to the ridiculously low level of £1 equals \$1 . . . short with *impunity*." "Crude oil will fall to between \$8 to \$10 per barrel by the end of '83. Short positions may be added to with *impunity*." "The imminence of default allows us to be long bills against short Euros with *impunity*." If you inferred we meant you would actually achieve these pie-in-the-sky objectives—and, in fact, we did mean exactly that—without risk, then we apologize. Using the word "impunity" in the contexts we intended leaves us candidates for the malapropism-of-the-year award.

### Little light of the year

Copper. We were fairly luminous. Going into the year, we were long as per our advice rendered during the summer of '82. (Assiduous readers may recall the declaration that "copper prices at 55 had achieved a low which would probably not be seen again during the lifetime of any reader," won last year's award for most audacious call—the award will not be offered this year.) The market opened the year at 78, basis July. We had a target of 85. In May we took profits at 81 and went short, looking for lows registered in March. A month later the March lows of 74 were realized. Not bad.

### Contributors

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### Hotline

Call (416) 364-1198 for a recorded update on recommendations in this issue. Recommendations are update every Tuesday and Friday after the close of the market. Emergency updates anytime.

## Give me an aspirin; I'm in love with a yo-yo without a string

No matter how stupid it sounds, it can't be more absurd than expending as much ink, breath, energy, and money on our heating and gas oil positions as we have when one considers that the March '83 heating oil contract began the year at 80.08 and the March '84 position ended the year at 79.30.

Are we trying to tell you now that we let you suffer through a move down from 84 to 72 in the first month of the year, a move up from 72 to 89 during the next seven months of the year, a move down from 89 to 73 during the next five months, and a move up from 73 to 81.50 in the last two weeks alone all for approximately \$327.60, not including commissions? And that we let that happen, all the while predicting oil would fall to between \$8 and \$10 a barrel before December 31? And that we said you could do it with "impunity"?

That's right. That's what we're trying to tell you. Would we ever do a thing like that again? Let's put it this way: If oil isn't less than \$20 per barrel 12 months from now, Al Friedberg promises to eat this typewriter.

## The real trade of the year

Or why we'd jump out the window if our offices were higher than the second floor: Cocoa.

In a year during which we were generally ludicrously bloated with hyperbole when analyzing markets of little dimension, we left ourselves tentative in discussing the major bull market of 1983.

In January we argued strongly that cocoa was a "nascent" bull market. Our trading advice was to purchase "lightly." In February, after the market had advanced 20% in 30 days, we advised liquidating half our position. In March, after the market had fallen as per our expectations of February, we "suggested" those without positions should get long. In April we were once again very bullish and concluded: "Prudence restrains us to maintaining an initial target of 2,050." By June, our "initial" target had been achieved, and we recommended liquidating half our position with close stops. By July, we had been stopped out and advised re-entering the market 30 basis points higher. In August we predicted the cocoa market would rise to between 2,700 and 3,000, basis nearby. But by August, we had been sold out as per our far-too-defensive stops and, lacking gumption, advised as follows: "Maintain the lightest of investment-type long position."

Cocoa began 1983 at 1,623, basis nearest futures contract. It ended at 2,750 as predicted in August. We predicted with prescience. We advised like kittens; the traders could barely be persuaded to be long at all. We could have been ahead by \$11,270 per position at this point. For the author, nothing, not even the disastrous gold play in March, is more painful to recall.

For all of the above, our cocoa play deserves the No-light-of-the-year award.

## Boar of the year

Being short April hogs from the start of the year at an average of 55.5¢, covering about 48.67, selling December hogs on the rally, at 47¢, and covering about 40.82, gave us the *boar-of-the-year* trade. The lowlight of the year trade in meats was getting stopped *into* July pork bellies on the long side in March, *the day of the hog report*, and promptly getting stopped out roughly three days and three limit-downs later. However, a record of 23 recommendations in meats, 18 profitable, 12 of those yielding profits in excess of 100% of margin, and only one trade with losses of slightly over 100% of margin should not be placed in the *boring* category. Would that the same be repeated in 1984.

## Most miraculous trade in meats

Long August pork bellies: . . . sell "if by a miracle, we reach 68¢." Twenty-two days, and 19.80¢ higher, August bellies reached our target, peaked at 72.57, and collapsed with almost five successive limit-down days. Unfortunately, those who rolled positions into February, as we advised as of August 1, took only(!) 12.20¢ profits, instead of 19.80¢.

## Spotlight of the year

Being caught red-faced, pants down, between market letters, during the biggest bull market in grains in years, having recommended being short at higher levels than those existing at press time (no pity!). Remorsefully, we were stopped out a very few short days after that writing, having "missed the boat," as it were. Towards the end of the year, we found ourselves again in the spotlight, but beaming, rather than gleaming (red-faced and teary-eyed), having discovered that we had sold corn less than a nickel from the highs and had bought it back less than a nickel from the lows, for 47¢ profits, in two trades. All in all, however, the year in grains ended slightly in the red, to match our red eyes, having missed virtually the whole bull market in one month between July 14 and August 11.

## Auld Lang Syne

We began by saying the year was awfully dull. Before putting things to bed, as it were, it behooves us to elaborate just a bit more.

Commodity and currency futures markets thrive on economic crisis. Actually, they thrive on perceptions—real or imagined—of economic crisis. During 1983, we emphasized in our *Comments* the dreadfully serious implications of the international debt problem, of the abhorrent illiquidity created by the mismatch of bank assets and liabilities and of the inevitable demise of OPEC owing to their insistence upon maintaining an artificial price for the world's most important commodity. The financial markets did not heed our *Comments* this year. Instead, traders paid attention to the relatively low and stable level of price inflation and to the apparently healthy and long-awaited recovery. This is not surprising; traders have a tendency—one which usually proves ultimately disastrous—to attend to the obvious.

Does this mean we've been wrong in screaming about looming crises? In screaming, perhaps. But not in mentioning them. For, in truth we are sorry to have to admit that the precipices we looked over throughout the year still stand

very directly in front of us. When the stampede to jump begins, our views will be tragically vindicated. Sad to say, the commodity and currency futures markets will then be the only place to be.

## When the debtors said no

By Anatole Kaletsky

*RIO DE JANEIRO, August 30 (UP) — Official announcement that a partial moratorium had been obtained on foreign debt payments was made today by the Brazilian Government publicity bureau. The Government, it was stated, has decided to suspend temporarily foreign debt payments with the exception of two funding loans and the Coffee Loan.*

These two sentences, which hit the world's financial markets like "a bolt from the blue," in the words of the following day's Financial Times, had certainly not occurred to Mr. Thomas W. Lamont, senior director of J. P. Morgan and Co., on Friday, July 25 the year before Brazil went bust.

At 3 pm that Friday afternoon Mr. Lamont, in his capacity as chairman of the International Committee of Bankers on Mexico, felt nothing but pride and satisfaction as he ushered Sr. Luis Montes de Oca, the Mexican Finance Minister, into the Morgan Bank's opulent boardroom in Wall Street.

History seemed to be peering over his shoulder as he added his signature to that of the Finance Minister on the agreement which brought to a successful conclusion the biggest-ever renegotiation and settlement of a defaulting country's foreign debts. Here at last was a piece of good news which could provide a ray of hope to the financial world after a year of continuous disasters, the likes of which the world had never seen.

The hope was dimmed, but not yet extinguished, on New Year's Day five months later when the Bolivian Legation in New York issued the following statement:

"Owing to the current worldwide business depression, the general revenues of the Republic of Bolivia have been temporarily reduced to such an extent that the Republic is not in a position at this time to meet the interest obligations which became due on its external debts on January 1."

Bolivia intended "to fulfil its obligations fully and absolutely," the statement added. But it would need the indulgence of its creditors for a temporary period because of the country's exceptional dependence on exports of tin.

It seemed to be another "special case" that landed three months later on the desk of Mr. Charles Mitchell, chairman of the National City Bank of New York. The plaintive letter on his desk from Peru's new Finance Minister, read (in part):

"I am addressing you with respect to the interest due

April 1 next on the Peruvian National Loan. This Government took office on March 11 last, after a period of political disturbances extending over six months. It finds the Treasury bare of funds, both as a result of these political disturbances and of the economic depression which has obtained for more than a year. As a result of these conditions, for which the present Government is not responsible, it has not the capacity at this time to pay in full the service charges on the Republic's entire debt."

By the end of that summer, it was no longer possible to talk of "special cases."

In July, two months after Peru's letter, Mr. Mitchell received a cable in almost identical terms from the Government of Chile. Then, a month later, on August 30, came Brazil's "bolt from the blue."

With Brazil's "temporary" moratorium, the floodgates were opened. Cables poured in from Ecuador, Colombia and Central America. Within a year only three major Latin American countries—Argentina, Venezuela and the Dominican Republic—were meeting their obligations in full. Soon Hungary, Yugoslavia, Romania, Poland and Bulgaria were also in default. Finally, even Germany blocked its foreign payments as its tough new leader—Adolf Hitler—consolidated power.

Until that last sentence, even the reader with a moderate interest in international finance might have wondered whether all these references to governments "defaulting" and "going bust" were supposed to be fact, forecast or just plain fantasy. After all, it is common knowledge today that countries cannot just "go bust." A government can always pay its debts if the nation is willing to accept temporary sacrifices. Even the most impetuous politicians realise that deliberate default can be tantamount to national economic suicide.

### 'Common knowledge' has forgotten about history

These fundamental truths have been proclaimed so vigorously in recent months, as Latin America and Eastern Europe have appeared to approach the brink of bankruptcy, that "common knowledge" has entirely forgotten about history—about the wave of national defaults which swept through precisely these same regions in the 1930s.

This collective amnesia about the international lending disasters of the 1930s has two possible explanations.

The sovereign defaults in Germany, Austria and other central European countries were due not to excessive

commercial borrowing, but to the unupportable burden of reparations from the First World War. The vast sums involved in these notional defaults on essentially political obligations have tended to divert attention from the sovereign defaults on purely commercial debts. Yet the commercial defaults had mounted to roughly \$3bn by 1933—a huge sum in the context of a value of only \$24bn for the whole of the world's trade.

Secondly, the international borrowing of the 1930s came mainly from investors in the bond markets, rather than from banks. This left the banking system less exposed to sovereign defaults and bankers themselves less preoccupied by their consequences.

But, despite this important technical difference, the parallels between the debt crises of the 1930s and the 1980s are more than just an historical curiosity.

The superficial features of the 1930's debt crisis should be familiar to anybody who has been following the events of the 1980s.

There was, of course, the geographical distribution of the defaulting nations.

From 1931 onwards the U.S. Congress (with Mr. Lamont of Morgan and Mr. Mitchell of National City as the first two witnesses) held indignant hearings on the bankers' "scandalous practices and abuses" in pushing loans during the 1920s on unsuspecting foreign dictators.

Commissions of international financial experts—such as Sir Otto Neimeyer of the Bank of England and Professor Edwin Kemmerer of Princeton University—were despatched from Peru to Poland by committees of bankers or by the League of Nations to restore confidence.

But even more interesting and ominous are the possible lessons for the future.

Defaults in the 1930s invariably proved much deeper, longer and more subtle than anybody had expected. Just one month before Brazil began its default on August 30, 1931, for example, Sir Otto found "that Brazil had all but turned the corner on her difficulties."

On December 18, a group of bankers told the New York Times that Mexico had "reached a stage of economic convalescence" and could expect "a period of rehabilitation which will compare favourably" with other major countries. On January 22, 1932, a special session of the Mexican Congress declared the country's agreement with the Lamont committee "a nullity" and suspended all loan payments for three years.

Misapprehensions like these stemmed partly from a curious paradox, which may also prove instructive in the 1980's debt crisis. Governments became more stubborn in their defaults precisely when their economies started *improving*.

Sir Otto and the bankers were partly right in their economic predictions about Brazil and Mexico. They *were* recovering by 1932—in fact Brazil's industrial production grew by 11.8 per cent a year from 1932 to 1939. But as these countries consolidated their ravaged economies and returned to political stability, their determination and ability

to withstand pressure from foreign creditors grew as well. This is exactly what many Brazilians and Mexicans today expect their governments to start doing in the next year or two.

No nation in Latin America explicitly repudiated its debts, but by 1933 there was no longer any thought of "loyalty complying" with external obligations, as promised in the Peruvian letter to the National City Bank in 1931. Indeed, when the Mexican President asserted publicly, in September 1933, that "the present and future financial policy of the Government does not permit of any idea of renewing service on the foreign debt," his statement did not even rate a report in the financial press.

The bond market even picked up slightly when Brazil converted its "temporary" moratorium into a permanent default by stating that it would issue newly-printed bonds for 20 and 40 years in lieu of cash interest payments.

Of course, the major debtors took liberties with their "obligations," partly because the U.S. and British Governments let them get away with it. But here is another lesson from the 1930s. The creditor governments did not unleash retaliatory trade measures against the defaulters or ostracise them from "the community of nations." On the whole, they blamed bankers for "overlending," more than the debtors for failing to pay.

The U.S. and British Governments' insouciance stemmed not just from conscience, or even political expediency, as World War Two made the preservation of alliances in Latin America paramount. Both governments also seemed to remember the lessons of previous history better than their bankers.

### **A well-established 50-year cycle of default**

Since the 1820s, Latin America had defaulted en masse repeatedly. The losses of the 1930s were accepted as just the latest turn of a well-established 50-year cycle of default, followed by further massive extensions of credit. Experience had shown that lenders had only one real sanction against sovereign defaulters—cutting off new credit.

Normally, after a lengthy period of default a country would seek to re-establish its credit by offering its bondholders a "readjustment," settling their outstanding claims for a fraction of their face value. Most of the Latin American and Eastern European countries lifted their defaults like this in the 1940s and 1950s. Mexico was one of the first in 1943, when it persuaded the Lamont committee to recommend acceptance of less than \$50m in settlement of more than \$500m of outstanding debts.

The bondholders reluctantly agreed, on the grounds that some payment was better than nothing—and also because many had bought the Mexican bonds as pure speculations at knock-down prices during the country's many protracted periods of total default between 1914 and 1943.

Once an adjustment was agreed by bondholders, the stigma of default was officially expunged and the country could again start seeing credit. Mexico was allowed to

borrow from the U.S. Exim Bank as early as 1942, while it was still negotiating with the bondholders, but after it had settled other outstanding claims against it, following the expropriation of U.S. oil companies. Slowly but steadily, it returned to its pre-eminent position as one of the world's greatest debtors.

Nearly four decades later, in April 1981, the Mexican Government approached the sterling bond market for a loan of \$50m on behalf of Pemex, the state oil company. The following sentence appeared in the prospectus:

"Full debt service has been paid when due upon all the external debt issued by the Federal Government of Mexico

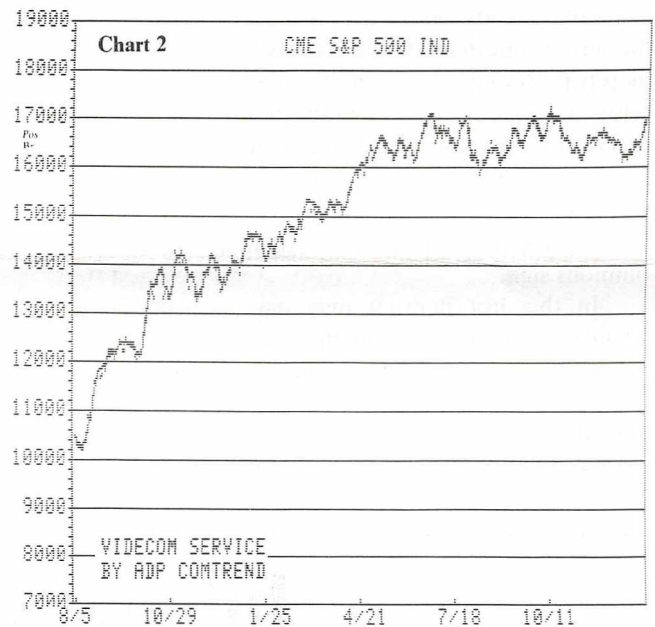
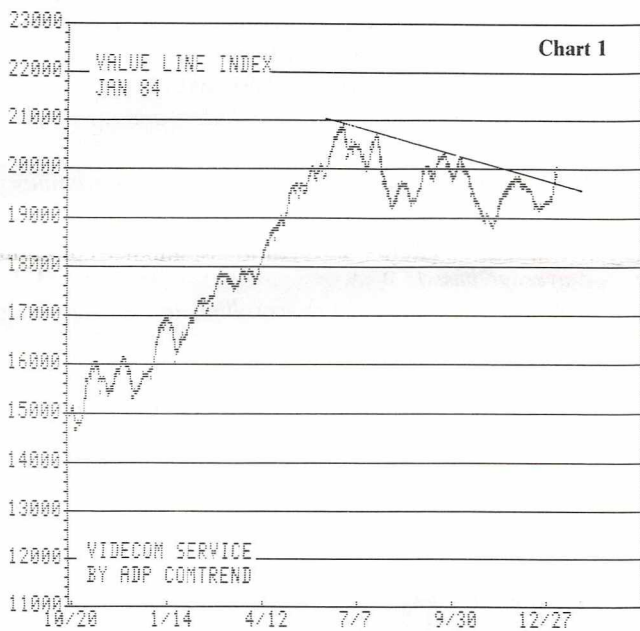
since the adoption of the constitution of 1917 . . ."

The prospectus did not bother to explain this enviable record. For nearly 30 years, from 1914 to 1943, Mexico had defaulted on most of its pre-1914 obligations and was therefore prevented from raising new loans on which it could commit any "fresh" defaults.

That is the sort of fine point that bankers seem willing to leave to the history books.

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## Stock Index Futures



After a sixth and unsuccessful attempt by the S&P 500 Average to drop below the critical 160 support level, US stock prices firmed and later soared on record volume, ending what appeared to be a long period of consolidation. Last week, on the NYSE composite tape, advances held a cumulative plurality of 2,256 issues over declines, the most respectable showing in many months, while net new weekly highs recovered to a mildly constructive 157 issues. Finally, an important six-month downtrend in the broad-based Value Line Index (Chart 1) was penetrated, while the two principal Dow Averages came within a hairsbreadth of recording new highs.

As significant as the rally was, it left a great deal to be desired. In the first place, the relatively meager specialists' short-selling activity and correspondingly relatively heavy public level of short selling during early December was extremely well publicized and widely heralded as a harbinger

of higher prices. The same can be said about the unusually high *short interest ratio*. Never have so many grasped at so little to justify continued optimism. The new breed of technicians chose to emphasize the positiveness of the sentiment indicators over the particularly unappealing condition of other indicators. Instead, even with the most recent recovery, market breadth on the NYSE is worlds away from matching its May-June peak while the Amex advance-decline line just managed to come off levels first reached in August 1982, having totally obliterated the 1982-1983 bull market!

The dramatic reaction to disappointing estimates during recent weeks (including last week) underscores the market's high level of expectations, a state of mind far more closely related to market tops than to "second legs" of a bull market. Other worrisome developments are: the falling (and

already extremely low) level of institutional cash reserves: soaring margin debt, to which one must add loans made by the banking system to purchase entire public companies (leveraged buy-outs); a *synchronized* worldwide equity boom that has, for instance, taken leading Japanese stocks to insane multiples of 25x and 30x, and 200-300 percent premiums over book values; and the amazing US new issue market that has seen more initial public offerings so far this year than the combined last dozen years. That speculation is rampant can also be gleaned from the findings that out of 40 big Savings and Loans in the US, 86% are acting as joint venture partners, 69% are mortgage bankers, 52% are going alone as developers, and 25% have moved into syndication: *Bankers*, bidding freely for deposits shielded by an explicit US government guarantee, don't anymore know what to do with their money, turning into wild crapshooters!

The complacency about owning stock is derived, no doubt, from complacency over future economic activity. One should note, however, that the recovery is almost two years old already, and is giving signs of slowing down; that the serious international debt crisis has not been solved but merely postponed (for an interesting perspective of a similar crises 50 years go, see "When the debtors said no," earlier in this issue)—it will inevitably end in tragedy; that the strange recent acceleration of loan demand has less to do with real economic activity (as evidenced by the continuous absolute and relative fall in inventories) than with speculation—an ominous sign.

In this last item, it may pay to heed closely Fed Chairman Volcker's comments. In remarks prepared for delivery to a joint meeting in San Francisco of the American Economic Association and the American Finance Association, the Chairman of the Fed said that to win the battle against inflation, expectations of rising prices must cease

being a "pervasive influence in economic and financial behavior." While recent price indices provide a "happy contrast" to earlier times, he added, the "insidious pattern" of rising inflationary expectations has not been entirely broken. Aware of the rising tempo of speculation (a product of easy money and inflationary expectations) the Fed may have issued a classic warning, pointing to the fallacy of relying on price stability. In much the same way, the late '20s were low on *price* inflation but high on *monetary* inflation.

**STRATEGY:** *In recent Hotline updates, we suggested covering all S&P 500 short positions at market. The early listeners were fortunate enough to lack in approximately a 300 point profit from the initial sale recommendation made in September. We are strongly inclined to trade this market from the short side but prefer, at least for the moment, to stand aside until after the stampede has lost some vigor.*

*If, as we assume, this is the bull's last dying gasp, some or all of the following signs and characteristics will appear:*

1. Strong price leadership by an increasingly smaller group of stocks, which will show up as (a) the Dow average outperforming the S&P 500, (b) the S&P 500 outperforming the Value Line Index, and (c) another breadth (A-D line) non-confirmation
2. A widening of the March '84 and June '84 premium
3. A return to a very low level of odd-lot short-selling activity (1,000 shares and under on a 10-day moving average basis)
4. A pick-up in specialist short selling activity (information normally delayed by two weeks)
5. A downside weekly reversal in the major averages.

*Should you detect some of these signs in the days and weeks ahead, be sure to stay in close contact with our Hotline.*

## Interest Rate Futures

**STRATEGY:** *Retain long March '84 T-bill/short March '84 Eurodollar spread.*

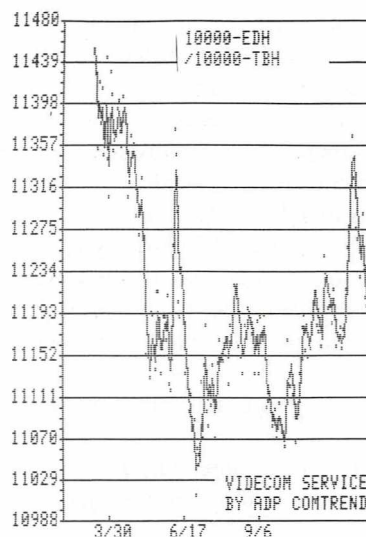


Chart 3

# Currencies

## The US steamroller

For months on end we have argued that the US dollar was not overvalued and that the pundits predicting a demise of the US dollar would suffer grave financial punishment. Now, a scholarly journal, no less than the November issue of the *Review*, published by the Federal Reserve Bank of St. Louis, backs our views. As the title of the article makes quite obvious, "Five common myths about floating exchange rates," the Fed attacks 5 myths widely used by the press and other pseudo-sophisticated publications.

In particular, discussing the widely held notion that the US dollar is overvalued, the bank demonstrates that owing to interest rate movements, among other things, short-run departures from purchasing power parity are common. Instead, the St. Louis bank prefers a somewhat weaker form of this classical condition, the *relative* purchasing power parity (RPPP). "According to this criterion, the exchange rate should *change roughly* in accordance with *changes* in inflation rate differentials." It then proceeds to illustrate this relationship (Chart 4), where a clear correspondence can be seen: Changes in the trade-weighted exchange rate reflect changes in the trade-weighted inflation rate differential. The US dollar does not seem to be particularly overvalued, as it is merely reflecting differential rates of inflation.

What about the yawning trade deficit? Here, again, the St. Louis *Review* points out that "currencies flow between countries not only to finance merchandise trade but also to finance investment (capital flows) and to pay for services . . . hence exchange rates reflect all these flows . . . thus the balance of trade that is relevant for anticipated exchange rate movements is not the merchandise trade balance alone but rather the more inclusive current account balance, which includes services and government transfers as well." In Chart 5 one notes that the current account balance fluctuates around zero in the 1973-1983 period despite the disparate movements of the trade and services balances. Furthermore, during this period, movements in the current accounts did not explain movements in the trade-weighted exchange rate. "Consequently," concludes the *Review*, "a continuation of deficits in US merchandise trade need not cause a depreciation of the US exchange rate."

In past issues of *Comments* we've shown that differential rates of economic growth are probably accountable for the widening trade deficit. If so, a slowing US economy and a slightly faster European and Japanese recovery will tend to narrow the US trade gap in coming months—but again with no obvious effect on the US currency. There is little doubt that the US is benefitting from persistent capital flows, which are a result of the high real rates of interest prevailing and/or investment opportunities in the equity and real estate markets. Until foreign residents *perceive* that these

two investment areas have become overvalued and the level of real rates has fallen somewhat, the greenback will continue to appreciate. Technical factors are likely to cause a *dramatic* "rush to the top," an issue we have repeatedly discussed.

A note on the Japanese yen: The relentless decline of the DM vis à vis the dollar and the stability of the yen/dollar parity has moved the yen/DM cross rate to a record low of ¥83/DM.

There is something "fishy" in this parity: We are absolutely convinced that *it is not the product of market forces*. Using purchasing power parity statistics with a 1970 base and "purely" domestic (non-tradeable) price indexes, such as Japanese costs of private construction works and a German index of costs of residential buildings, yields a more "proper" parity of ¥110/DM. While official international reserves of the Bank of Japan have barely moved, indicating a lack of official intervention, it is well known that Japan possesses "hidden reserves" in the form of official dollar holdings at commercial banks. (In our next issue, we will attempt to dig out these numbers.) Be that as it may, the Japanese must be running down these reserves in a desperate attempt to maintain a strong yen and avoid retaliatory US and EEC trade measures. Whatever the size of these reserves, they will eventually be exhausted if the Japanese move against market forces. As a result, the Japanese yen presents an ideal one-way bear speculation, with *some* risk should the US unit weaken substantially.

**STRATEGY:** *Remain short all currencies with particular emphasis on Sterling, the French franc, and the Deutschemark. As we stated last month, the relative strength of the Japanese yen and Swiss franc is illusory, for they cannot stop (except by some sort of Herculean but quite finite intervention) the steamrolling US dollar. The possibility that the Japanese may be exhausting their "hidden" international reserves presents an intriguing bear speculation, although we should note that their official (and open) reserves stand at a formidable \$24 billion, which may be used, at least partially, before they throw in their towel.*

## Canadian dollar

Recently-released international reserve figures indicate that Canada's net official monetary movements swung to a minus US\$720 million in the fourth quarter of 1983 after recording positive flows of US\$712.8 million, US\$382.50 million, and US\$218.5 million in the first 3 quarters of the year. The underlying loss in December of US \$570 million was particularly severe as the Bank of Canada attempted to maintain the C\$ above 80 US cents.

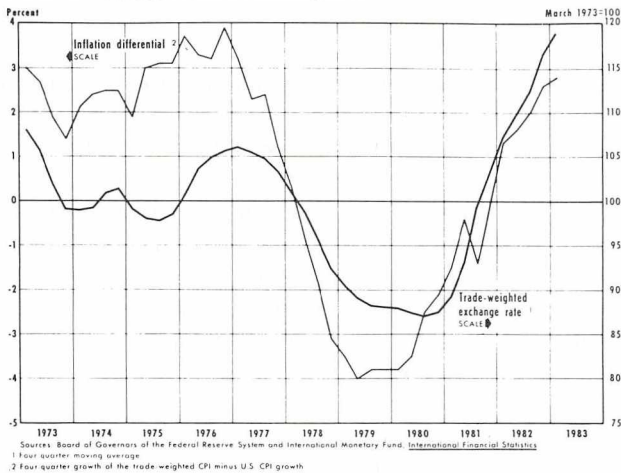
While monetary policy has as yet not turned expansionary, there has been a slight increase in the past four months in the Bank of Canada's adjusted monetary base, which may indicate that the Bank is targetting a more accommodative monetary policy. If so, it comes at a

particularly difficult moment, in view of severe exchange pressures.

**STRATEGY:** *Hedgers should maintain, for the moment, a short position in the C\$.*

Chart 4

The Inflation Differential and the Exchange Rate

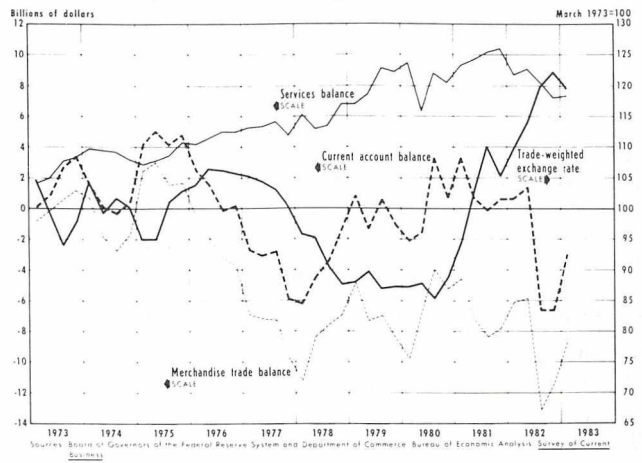


Sources: Board of Governors of the Federal Reserve System and International Monetary Fund; International Financial Statistics  
 1 Four quarter moving average  
 2 Four quarter growth of the trade-weighted CPI minus U.S. CPI growth

Source: *The Federal Reserve of St. Louis Review*

Chart 5

The Balance of Payments and the Exchange Rate



Sources: Board of Governors of the Federal Reserve System and Department of Commerce Bureau of Economic Analysis; Survey of Current Business

Source: *The Federal Reserve of St. Louis Review*

# Precious Metals

All major trends remain down with ultimate objectives of \$250/oz. gold and \$4.50/oz. silver.

**STRATEGY:** *As long as the US dollar remains as strong as it has been, it is impossible to countenance a genuine reversal in gold's long bear market. From time to time, however, the market appears to find temporary respite and begins to "act" as if it wants to launch a significant rally. One such "apparent" intermediate bottom fooled us a number of weeks ago, especially having been accompanied by a fairly*

*large increase in the open commitment, a sign that something was amiss.*

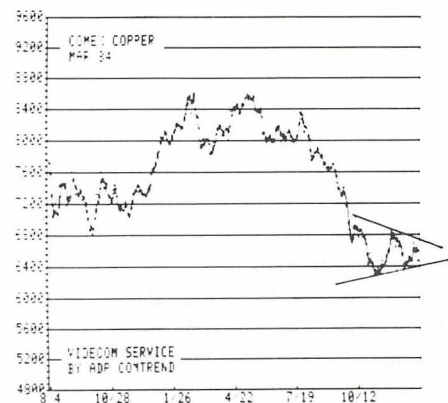
*Although we were temporarily correct, and the market managed to post some gains following our short covering advice, the rally was cut abruptly the day after New Year, and new lows were being recorded toward the end of the week. By Friday afternoon, with spot hovering around \$371 oz. we advised, over the Hotline, reinstating short positions in gold and silver. Place new stops at \$390 oz., basis spot gold and \$9.40 oz., basis March silver.*

# Copper

A most interesting technical formation has appeared in copper futures: a descending triangle, with an upward slanting bottom (see Chart 6). A significant move should follow either an upside or a downside breakout: a rare opportunity to cash in on a technical formation.

**STRATEGY:** *Buy on March '84 breaking out above 68.60, close only; sell if March '84 copper closes below 63.20, close only. Should the breakout occur on the upside, accept a 500-point profit on half the position and ride the balance. Should the breakout instead occur on the downside, accept a 500-point profit on the entire position.*

Chart 6



# Energy Futures

## Where the mystery deepens . . .

The late-December bitter cold snap in North America found energy followers unprepared: in a short four trading sessions, heating oil prices rose a staggering 12%, crude oil and gasoil somewhat less. Could the market really be that short of product or is it the continuing victim of an oil myth that is still as hard to break as its price. The latter is a far simpler explanation of an event that, at most, *and if continued an entire season*, could represent an incremental demand of 0.5 million barrels per day (mb/d) in world markets for the duration of the winter.

On the other hand, unseasonably warm weather in Europe and the soaring US dollar could be counted to at least offset the effects of American fridity. As if to underscore the bearish European scenario, Exxon Corp.'s West German unit reported that West German oil consumption fell below 2 mb/d in 1983 for the first time in 15 years. Consumption in 1983 had fallen 2% from 1982 and stood a full 25% below the record 2.66 mb/d recorded in 1979.

Polar temperatures did little to restore profitability to the products markets, where refinery margins remain negative. In the US Gulf Coast market, the net-back value of refining Saudi Light rose \$1.10/barrel, but the implied margin still remained at minus \$2.20 per barrel. Similarly, the implied refiner's margin on Nigerian crude (Bonny Light) now stands at minus \$0.82 per barrel. While the *improvement* in Europe was smaller, the negative margins also remain smaller: \$1.83 per barrel for Saudi Light and \$0.44 per barrel for Bonny Light. Such substantial negative margins must eventually cause crude prices to tumble.

Leaving weather and margins aside, we turn our atten-

tion to the continuing puzzle of a(n inexplicable) build up in stocks. The Paris-based International Energy Agency (IEA) reports that OPEC production in the fourth quarter of 1983 remained at 18.8 mb/d, substantially in excess of its self-imposed ceiling of 17.5 mb/d. It also finds that a large and unexplained proportion of that output found its way neither into the market nor into officially monitored petroleum reserves. While OECD stocks were drawn down at a rate of 300,000 b/d, stocks outside the OECD rose by implication by a very large 1.2 mb/d.

The IEA believes that the Saudis and some oil companies stockpiled quietly in anticipation of supply disruptions in the Strait of Hormuz but only as much as 500,000 b/d might be accounted for by the two sources. Of course, it could turn out that the IEA's consumption figures of 34.9 mb/d for the fourth quarter of 1983, up from 34.4 mb/d in the same quarter of 1982, may have been understated. Or it could turn out, as we speculated last month, that *the Saudis have stockpiled a great deal more oil than is suspected* for the purpose of carrying out a dramatic one-time reduction in price and maintaining it at the lower level for long enough to establish the new quote. Only time will tell and spring is not too far off . . . In the meantime, the IEA reports that supplies remain burdensome, equal to 96 days of forward consumption.

**STRATEGY:** *Unlike the famous episodes of bear speculations against Sterling in the mid '60s and the French franc, in early 1983—totally routed by skillful bear squeezes put on by the Bank of England and the Banque du France—bear speculators in oil need not worry: It is a one way street, despite the weather. All your need is a little bit of patience. When the payoff comes, you will wonder why, if the risk is minimal, you did not sell more. Remain short; ignore stops.*

## Cocoa

The bull market could not carry on unabated. The current pullback in this strongest of markets in 1983 through into 1984 was set off by a very overbought condition, coupled with the realization that Nigeria, supplier of roughly 10% of the world's cocoa, should not experience any supply disruption from the recent coup.

The market continues to rise on the forecast of a global deficit in 1983-84 of 120,000 to 180,000 metric tons (mt). It was aided by reports that brush fires in Ghana would reduce

that state's production to 150,000 mt in 1983-84 from 170,000 mt in 1982-83.

A shortage of available supplies and the prospect of continuing annual deficits should eventually power this market ever higher.

**STRATEGY:** *Maintain long investment-type positions in March, retaining stops at \$2,380 a tonne, close only.*

# Grains

At the risk of sounding like a stuck record, we repeat that "our outlook remains long-term negative based on our analysis of continuing strength in the US dollar. . . . The US dollar remains king."

At this juncture, we would hypothesize that grain and soybean prices are in the low end of a trading range that should provide the boundaries for prices in the first four months of 1984. These boundaries should be 3.45-3.85, basis March wheat, 3.15-3.60 for March corn, and 7.20-9.00 for March soybeans. At the end of our four-month frame of reference, plantings of corn, soybeans, and spring wheat will be well underway, whereupon we'll be able to better judge the prospects for new-season crops.

Chase Econometrics has forecast planted acreages for 1984, as shown in Chart 7. You can see that planted acreages are forecast to rise very substantially in 1984, (especially corn compared with 1983) as farmers plant to replenish depleted corn and soybean carryover stocks and attempt to take advantage of relatively high current cash prices. (The chart also compares 1984 plantings estimates with 1982, a more "normal" year with no payment-in-kind programs.) As a result, carryover stocks of wheat, corn, and soybeans in 1984-85 will rise substantially, barring a repeat of the 1983 drought.

While we doubt the likelihood of a drought, keep the possibility in the back of your mind, as the consequences would be explosive, particularly for corn and to a greater extent, soybeans. Generally, two out of ten years have excessively dry weather; and surprisingly, those years tend to run close together.

Wheat carryover stocks currently provide the same cushion for 1984-85 that corn and soybean carryover stocks did in 1983-84. On December 22 the USDA estimated 1984-crop winter wheat *plantings* at 64.92 million acres, up 3.8% from the 62.50 million seeded for the 1983 crop, but *down* 2.3% from the 66.4 million acres seeded for the 1982 crop. The December 22 report was interpreted as bullish, compared with an average expectation of 68.0 million acres, in a range of 66.1 to 70.0 million acres. This lower-than-expected figure

is in keeping with the need for lower US wheat acreage as foreign governments excessively subsidize their wheat exports.

Once the EEC is bankrupt, for example, the US can return to higher production and exercise its comparative advantage over the EEC for wheat production. The low figure also supports our belief that the long-term trend for wheat prices is turning, and that being long wheat represents the best opportunity in grains, again barring the possibility of a repeat of the 1983 drought (In such an event, 1984 corn and soybean prices would probably outperform wheat, as in 1983).

The Chase Econometrics figures for winter wheat *harvestings* are consistent with the USDA figures for *planting* when you consider that generally, about 10 million acres of wheat (or well over 10% of total planted wheat acreage), almost all of it winter wheat, is abandoned (not harvested) each year owing to "winterkill." The abandonment of winter wheat in 1983 was much greater than normal as the payment-in-kind program for winter wheat was not announced until after winter wheat plantings were completed.

Updated world grain statistics will be released January 13 by the USDA, but should show little change when compared with the December report. Domestic US supply and demand projections will not be released until January 24, following the US grain stocks on January-report to be issued by the USDA on January 23. The grain stocks report should be the most important grain report in January, as it will show the extent of the reaction of demand for corn and soybeans, and to a lesser extent, wheat, to high post-drought grain prices in 1983.

For reference purposes, export commitments and seasonal export inspections data are shown in Chart 8. As we discussed in November and December, export commitments continue to slide relative to the year-ago season, when compared month-to-month in the current season.

**STRATEGY:** Retain positions only in July wheat, on the long side, with stops at 3.30, close only.

Chart 7

FORECAST 1984 PLANTED ACREAGES					
(million acres)	1984 est.	1983	1984 1983%	1983	1984 1982 %
Corn	83.56	60.13	138.9	81.9	102.0
Soybeans	71.40	63.34	112.7	72.16	98.9
Total Wheat(harvested)	71.28	61.42	116.0	78.98	90.2
- Winter Wheat(harvested)	55.03	47.24	116.4	58.49	94.0

\*Chase Econometrics bases its wheat estimates on harvested acreage rather than planted acreage because of greater statistical correlation (co-efficient of determination).

Source: CHASE ECONOMETRICS

USDA - winter wheat (plantings)	64.92	62.50	103.8	66.4	97.7
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Source: USDA

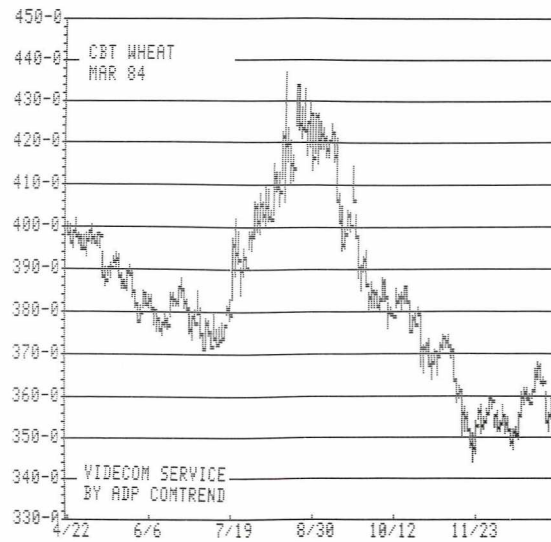
Chart 8

EXPORT COMMITMENTS AND SEASONAL EXPORT INSPECTIONS (through December 29.)

	Export Commitments			Seasonal Export Inspections		
	(Thousand metric tonnes)					
	1983/84	1982/83	1983/84 1982/83%	1983/84	1982/83	1983/84 1982/83%
Wheat	27,434.0	32,119	85.4 (91.1)	20,610.5	21,056.0	97.8 (92.4)
Corn	27,432.9	23,093	118.7 (131.0)	14,383.9	12,744.6	112.8 (113.6)
Soybeans	13,587.0	14,503	93.6 (98.9)	7,607.2	8,871.8	85.7 (85.3)
Soybean oil	119.6	-	-	62.1	199.6	31.1
Soybean meal	3,059.4	-	-	1,573.7	1,616.3	97.3
Cotton (thousand bales)	5,170.4	3,445.5	150.0	2,004.8	1,695.0	118.2

Source: USDA \* previous month figures in brackets.

Chart 9



## Livestock

The bullish environment continues. Cattle prices remain strong, not because of record cold temperatures, as happened in December, but because of muddy feedlots from a combination of heavy snowfalls and recent mild temperatures. Muddy feedlots last February caused tremendously strong cattle prices. Similarly, hog prices are very strong as they recover from record slaughter levels in the fall of 1983, and a change in sentiment inspired by the December 22 USDA quarterly hog report (see Chart 10).

The hog report was considered friendly (i.e., slightly bullish), based on: total hog numbers at 103.4% of last year, versus average expectations of 104.6%; and market hogs at 104.1% last year, compared with expectations of 105.7% more than the year earlier. The kept-for-breeding figures show 99.1% as many breeding sows as the year before, somewhat higher than average expectations of 97.7%. This, when considered with a pig crop (piglets born) forecast for December 1983 to May 1984 at 6.3% below the year earlier period, means that hog slaughter levels will fall sharply until the fall of 1984, whereupon they will begin to climb fairly sharply into 1985. This is implied because sows retained for breeding that will bring market hogs to sale after September are roughly the same as last year, when hog producers were in a mild expansionary phase.

After the end of January, daily hog slaughter should show a sharp decline, falling from an average of about 330,000 in the past two weeks, to 310,000 or less for February through May, to 285,000 or less in June through August, and to or below 275,000 average daily hog slaughter in the fall of 1984. This scenario foreshadows a repeat of the

1982 bull market in hogs, with similar record-high hog prices, and maybe even new record-high prices, when lower cattle slaughter numbers for summer 1984 and the greater resilience of the economy are considered.

With the same reasoning, the differential between cattle and hog prices should narrow substantially from the present 11¢ premium August cattle over August hogs, and the current 10.5¢ premium October cattle over October hogs. We foresee August live cattle over 75¢, and August live hogs approaching 70¢.

Upcoming are the January 18 quarterly 13-state cattle-on-feed report and the January 30 semi-annual cattle inventory report. Lower feeder placements and breeding cow inventory figures, respectively, compared with January 1, 1983, should serve to maintain the bull market in live and feeder cattle, and to support the bull market in hogs.

**STRATEGY:** Maintain long positions in June live cattle, raising stops to 65.5¢. Based on our Hotline advice, August feeders should have been sold around 65.25¢. Place orders to buy back August feeder cattle at 66.25 for outright positions. Maintain spreads of long August feeders/short August live cattle, risking a close below 140 points, premium the feeders. Raise buy orders in June hogs to 53¢, now that we know the implications of the hog report. Place stops at 51¢, close only.

Also as recommended on the Hotline, spreads of long 4 April hogs/short 3 February live cattle should have been entered on January 3, at a premium in excess of 19¢, cattle over hogs.

Chart 10

December 22 USDA quarterly hog report - December 1 data.

( '000 head)	1983	1982	$\frac{1983}{1982}\%$	expected
<u>50-state report</u>				
all hogs and pigs	55,819	53,935	103.4	104.6 (102- 107)
kept for breeding	7,352	7,415	99.1	97.7 ( 93- 101.5)
for market	48,467	46,519	104.1	105.7 (102- 108)
- under 60 lb.	18,753	18,628	100.6	102.9 (101- 105)
- 60 to 119 lb.	12,333	11,808	104.4	105.1 (103- 110)
- 120 to 179 lb.	9,771	9,282	105.2	108.0 (105- 110)
- over 180 lb.	7,610	6,802	111.8	111.5 (107- 118)
<u>sows farrowing-</u>				
- Dec.'83-May '84- <sup>fore-</sup> cast	5,900	6,221	94.8	96.7 Dec.- Feb. ( 94- 100)
- Sept.-Nov. '83	2,992	2,951	101.3	103.1 (101- 106)
<u>pig crop-</u>				
- Dec.'83-May '84- <sup>fore-</sup> cast	43,850	46,765	93.7	
- Sept.-Nov. '83	22,301	21,907	101.7	103.5 (102- 106)
<u>10-state report</u>				
all hogs and pigs	43,430	42,440	102.3	
kept for breeding	5,605	5,670	98.8	
for market	37,825	36,770	102.8	

Chart 11

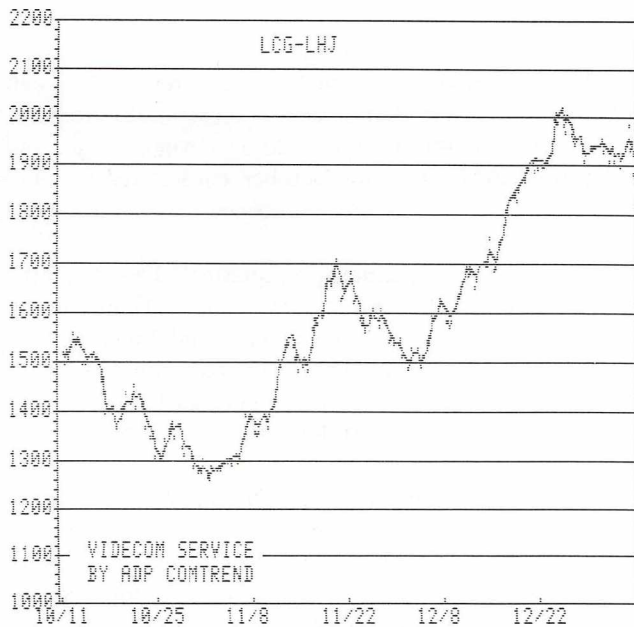
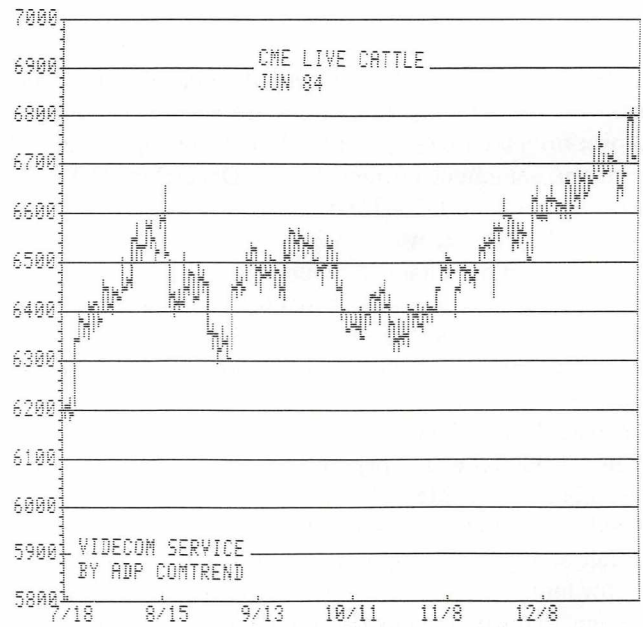


Chart 12



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